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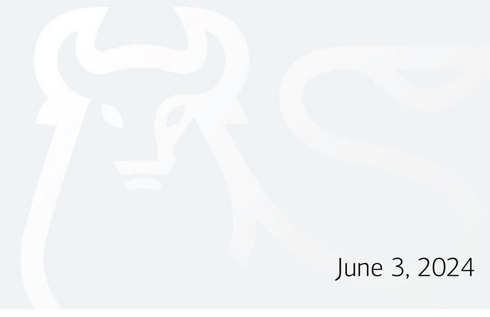
CHIEF INVESTMENT OFFICE

Capital Market Outlook



June 3, 2024

All data, projections and opinions are as of the date of this report and subject to change.

IN THIS ISSUE

Macro Strategy—*Dollar Strength Defies Skeptics:* Relatively more aggressive U.S. fiscal easing and tighter monetary policy have spurred widening growth and interest rate differentials between the U.S. and its trade partners. This has played a major role in boosting the dollar into overvalued territory in recent years. With U.S. inflation surprising to the upside and central banks overseas planning to cut interest rates more than the Federal Reserve (Fed) this year, the interest rate differential is likely to continue to favor the dollar, keeping it stronger for longer.

Still, cyclical and valuation considerations suggest the dollar is likely to depreciate ahead. In an increasingly multipolar world with growing geopolitical rifts, there's also apprehension about the longer-term outlook for the dollar. Surging U.S. government debt, large trade deficits, and higher-than-expected inflation compound this concern. The unparalleled dynamism of the U.S. economy and the established position of the dollar as a preeminent reserve currency and cross-border transaction intermediator make its demise unlikely anytime soon. However, downside risks to the dollar have increased.

Market View—*A Closer Look at May's Market Moves:* Equities resumed their grind higher last month after taking a brief breather in April, with the S&P 500, the Dow Jones Industrial Average and the Nasdaq Composite all achieving new all-time highs. Beneath the index level, we find that strength was relatively broad based—positive returns were observed in almost all of the S&P 500 sectors and cyclical areas like Small-cap and International also ended in the green. May's solid performance adds to an already robust run-up for Equities, leaving the S&P 500 up double digits in 2024 with seven months still left in the year. For investors wondering about what's next for markets, examining the drivers behind May's moves could offer insights. Improving corporate earnings, a "better-than-feared" inflation print, and increased expectations for monetary policy easing all acted as supports in May. While these factors are unlikely to fade in the near term, potential headwinds continue to mount. The risk for episodic volatility remains, but we maintain a constructive view on Equities and ultimately believe that the secular bull market remains intact.

Thought of the Week—*How Much More Can the World Import from China?:* At the start of the century, just five countries called China their top source of goods imports. Fast forward to today, and the second largest economy in the world is now the top source of imports for 66 countries—or roughly 1 in every 3 countries globally, per 2023 data.

And China's export footprint is only set to grow from here—or so it hopes. Already, excess capacity of clean technology products has fueled a dramatic uptick in the country's exports of electric vehicles (EVs), lithium-ion batteries and solar panels (the so-called "New Three"). The wrinkle? A rising tide of targeted protectionism from the U.S. and European Union (EU), not to mention mounting scrutiny from the emerging world. As regions pursue greater self-sufficiency, higher costs along renewable supply chains and slower global growth/trade may follow.

MACRO STRATEGY ▶

Chief Investment Office
Macro Strategy Team

MARKET VIEW ▶

Emily Avioli
Vice President and Investment Strategist

THOUGHT OF THE WEEK ▶

Ariana Chiu
Wealth Management Analyst

MARKETS IN REVIEW ▶

Data as of 6/3/2024, and subject to change

Portfolio Considerations

We maintain an overweight to Equities, with a preference for higher quality U.S. Large- and Small-caps, and still favor a significant allocation to bonds in a diversified portfolio. We maintain our view of buying into equity market weakness and maintaining exposure to Fixed Income for the purpose of cash flow and diversification benefits. Within Fixed Income, we still suggest a slightly long-duration position versus a stated benchmark to take advantage of higher yields, and as prudent positioning against macro risk in the increased Equity positioning of a diversified portfolio.

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Dollar Strength Defies Skeptics

Chief Investment Office, Macro Strategy Team

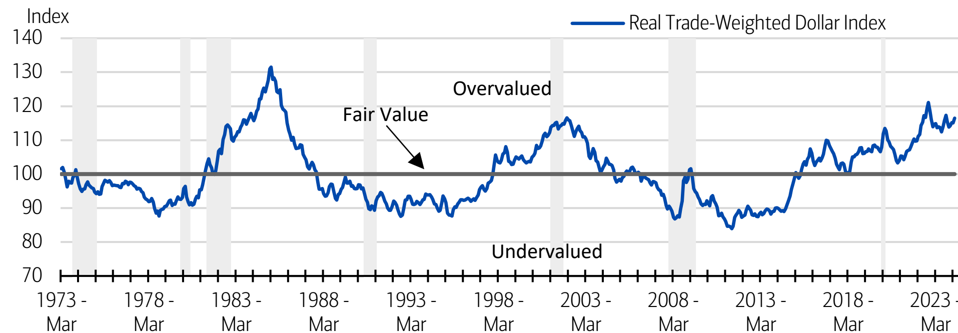
The U.S. economy remains the most resilient, dynamic, and innovative in the world, as reflected in stronger-than-expected growth, elevated corporate profit margins and earnings, as well as the strongest dollar in decades (Exhibit 1). However, in an increasingly multipolar world with growing geopolitical rifts, there's growing apprehension about the dollar losing its global appeal. Concerns about potential dollar depreciation due to untethered U.S. government debt have also increased.

For now, favorable U.S. interest rate and growth differentials—along with the strong allure of rapid U.S.-led technological progress—have sustained demand for U.S. dollars and dollar-denominated assets. The well-established role of the dollar and Treasury securities as "safe havens" has also continued to work in their favor. For example, despite much handwringing, overseas private-sector holdings of U.S. government debt have increased 53% since December 2019. Also, by late 2023, U.S. government debt accounted for about 11% of the estimated $250 trillion global stocks and bonds portfolio. Though up from 8% in 2019, this share still doesn't seem particularly high in the context of rapidly rising global wealth and growing need for "risk-free" assets.

In addition, the dollar accounted for about 58% of allocated, or identified, central bank foreign exchange (FX) reserves at the end of 2023, according to the International Monetary Fund (IMF), not far from 60.8% at the end of 2019 (though less than about 70% between 1999-2002). For comparison, the euro's share dropped from a 27% peak in 2009 to about 20% (the second-most held reserve currency).

The ultimate proof of confidence in the greenback is its 40% appreciation on an inflation-adjusted, or real trade-weighted basis, from its 2011 bottom to its 40-year peak in October 2022 (Exhibit 1). Even as the supply of Treasurys surged since the pandemic, it appreciated 8%. Having rolled over slightly from its recent peak, the real trade-weighted dollar (TWD) remains about 16% above its average. That is, about 16% overvalued.

Exhibit 1: Strong Demand Brings The Greenback Far Into Overvalued Territory.



Gray period represents recessionary periods. Sources: Federal Reserve Board/Haver Analytics. Data as of May 28, 2024.

The large and uniquely dynamic U.S. economy has thus continued to attract massive capital in search of strong returns and "safe havens." Its open, deep, and liquid capital markets remain key to the dollar's dominant role in the global economy. Fed liquidity facilities enabling adequate foreign central bank dollar funding to institutions in their jurisdictions also support the international use of dollars and global financial stability. So does the long-established dollar-based global payments infrastructure.

Until other countries successfully challenge the U.S. on these fronts, the dollar's status is unlikely to diminish sharply. Budgetary rules set European government debt growth on a more sustainable path compared to the U.S. Also, structural reforms and other measures have restored the euro as a viable currency following the 2011 to 2012 euro crisis. Yet, the lack of a unified government bond market to rival the U.S. Treasury market limits the euros' attractiveness as a reserve currency. In China, the heavy hand of the government undermines its currency's appeal as an alternative to the dollar. Restrictions on the free

Investment Implications

Signs of a cyclical pickup outside the U.S. bolster non-U.S. assets. Relatively stronger growth abroad and a likely dollar softening should boost the earnings of U.S. companies operating abroad compared to those mainly depending on domestically sourced revenues.

movement of capital out of the country are particularly problematic. Countries need readily available reserves to pay for imports, to service debt, and to avoid borrowing under duress.

...still, dollar risks are to the downside. While a dollar demise is unlikely anytime soon, the greenback is likely to gradually depreciate from current levels for a number of reasons:

- The real TWD index is overvalued. This index tends to mean revert: periods of extreme overvaluation are followed by corrections that take it back to average, or below average levels (Exhibit 1). The current dollar overvaluation resembles the early 1980s, when large fiscal deficits and tight monetary policy also drove stronger growth and higher U.S. rates. Once fiscal policy turns less stimulative and monetary policy eases, the dollar should move back toward fair value, as it did after 1984 despite dollar "exceptionalism."
- The dollar's countercyclical behavior suggests a depreciation is in store given evidence of global growth and trade regaining strength. Such an environment tends to favor pro-cyclical economies and currencies, such as those of more export-driven economies, to the detriment of the dollar.
- Emerging markets' (EM) macroprudential governance has improved markedly, boosting confidence in the stability of their currencies. As a result, the share of EM public debt issued in domestic-currency has risen substantially. This increases their resilience and reduces central banks' need for FX reserves, typically dollars.
- A diminishing global reliance on the dollar is both natural and likely as EM increase their economic heft. As EM economies expanded and advanced, the so-called "South-South" trade has surged. The "BRICS"[1] have added five more members since January, with numerous other countries seeking membership. The BRICS+ countries, seen accounting for 40% of the world economy by 2030, are evolving into a political and trading bloc, increasingly settling payments in their own currencies and considering the creation of a joint currency.
- Some countries are considering reducing their heavy reliance on the dollar in the wake of U.S. sanctions against Russia, as they no longer perceive the greenback and dollar-based assets as "safe." An increasing number of countries are evading the dollar-based payments system, continuing to trade with Russia in non-dollar currencies.
- China's efforts to promote the renminbi as an alternative to the dollar have intensified. These include efforts to expand the Chinese payment system it created as an alternative to the current dollar-dominated setup.
- The volatility of cryptocurrencies undermines their viability as a means of exchange. Thus, they're not an alternative to the dollar. However, central bank digital currencies (CBDC) could challenge the greenback if they enable frictionless payments that bypass the dollar and the system supporting its dominant position. Still, it will take time to understand the implications of CBDC on the U.S. and global financial system, as well as to implement this novel concept.
- Unrestrained U.S. government debt risks crowding out business investment and productivity growth, potentially undermining confidence in the U.S. economic strength and its currency. Also, "historically...every major inflation in world history is a fiscal phenomenon before it is a monetary phenomenon."[2] Concerns about negative effects of surging government deficits on the dollar are thus valid. Encouragingly, despite mounting debt levels, inflation has cooled significantly from its post-pandemic highs. Ultimately, the dollar's fate will depend on the Fed's commitment to low and stable inflation. Its expressed determination to bring inflation to its 2% target instills confidence on this front.

In sum, while increased adoption of alternatives to the dollar will take time, a gradual erosion of its dominant position on the global financial market stage is probably inevitable. Partial de-dollarization is here to stay. That said, fair value for the dollar is ultimately a function of its purchasing power compared to other currencies. Over time, currencies fluctuate based on differences in longer-term inflation rates, which will depend on the Fed's success in controlling inflation compared to its global peers. Unfettered government deficits risk making its task increasingly challenging.

[1] BRICS is an acronym for Brazil, Russia, India, China, and South Africa.

[2] Fiscal Dominance and the Return of Zero-Interest Bank Reserve Requirements, Charles W. Calomiris, Federal Reserve Bank of St. Louis REVIEW, Q4 2023.

MARKET VIEW

A Closer Look at May's Market Moves

Emily Avioli, Vice President and Investment Strategist

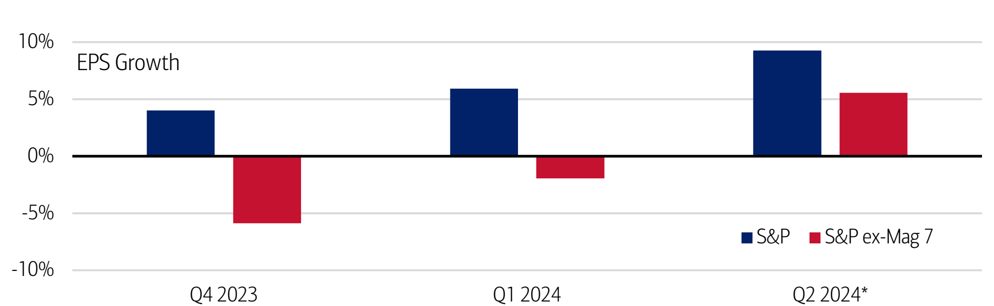
Equities resumed their grind higher last month after taking a brief breather in April, defying the age-old investor adage "sell in May and go away." The S&P 500 Index rose 5.0%, marking the best monthly total return since February. It surpassed two new all-time closing highs, bringing the year-to-date (YTD) total to 24, logged its fifth straight weeks of gains, and inched closer to the 5,400 level throughout the month. Meanwhile, the Dow Jones Industrial Average touched the symbolic 40,000 mark and the NASDAQ Composite crossed the 17,000 level for the first time.

Taking a peek below the index level, we find that 10 out of the 11 S&P 500 sectors were higher last month. Information Technology, home to many of the Artificial Intelligence darlings, continued to lead gains, but Utilities followed close behind and Real Estate, Materials, and Financials saw total returns in the low-to-mid single digits. While Large-cap Growth stocks were among the top performers, up 6.0%, certain cyclically oriented areas also finished last month in the green, with Small-caps, Value, and International Equities up by 5.0%, 3.2% and 3.9%, respectively.

May's solid performance adds to an already robust run-up for Equities, leaving the S&P 500 up 11.3% for 2024 with seven months still left in the year. For investors wondering about what's next for markets, examining the key drivers behind May's moves could offer insights.

Driver #1: Earnings improvement: Q1 2024 is shaping up to be the third straight positive quarter of earnings growth for the S&P 500, signaling a healthy recovery from last year's earnings recession. With 96% of companies reporting, the blended year-over-year (YoY) earnings-per-share (EPS) growth rate is 5.9%, marking the fastest pace of earnings growth since Q1 2022 and a significant move higher from the consensus estimate of 3.4%[3] before reporting season began. 78% of companies have reported a positive EPS surprise and 61% have reported a positive revenue surprise[4]. Also encouraging is that earnings strength is beginning to broaden out. S&P 500 earnings excluding Magnificent 7[5] earnings are -2.0% for Q1 2024, but that figure has significantly improved from -5.9% in Q4 2023 and is expected to flip positive beginning in Q2 2024 (Exhibit 2). Eight out of the eleven S&P 500 sectors are now reporting positive earnings growth, and cyclical areas are starting to see some green shoots. Of note, the Financials sector is reporting EPS growth of 7.7% and has seen the largest increase in revenues since March 31, according to FactSet. The latest earnings data signals that a new profits cycle is underway, which should continue to support Equities.

Exhibit 2: Earnings Strength Is Broadening.



*FactSet Estimate. S&P ex-Magnificent 7 refers to S&P 500 companies excluding Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla. Source: FactSet. Data as of May 29, 2024.

Driver #2: "Better-than-feared" inflation data: The April Consumer Price Index (CPI) fell to 3.4% YoY from 3.5% YoY the month prior while Core CPI, which excludes volatile components like food and energy, decelerated to 3.6% YoY from 3.8% YoY previously

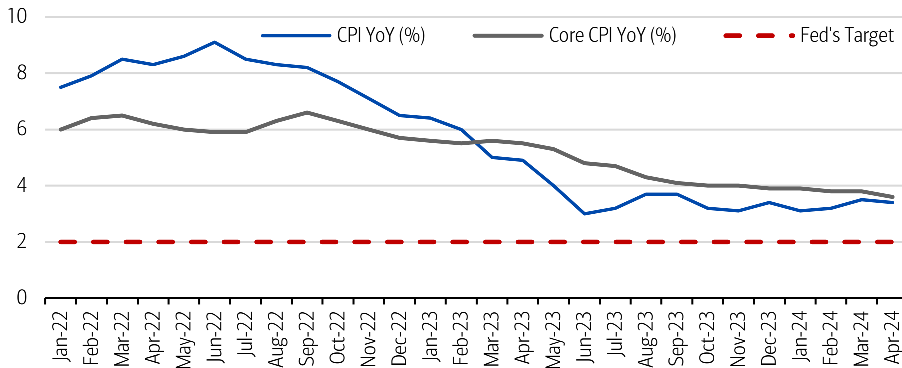
Investment Implications

The drivers that helped Equities grind higher in May, including solid corporate earnings, the gradual cooling of inflation, and expectations for the eventual easing of Fed policy, are likely to persist. While various tail risks remain, we maintain a slight Equity overweight from a positioning perspective.

[3] Factset as of May 31, 2024.
[4] ibid
[5] Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft and Tesla.

(Exhibit 3). After months of disappointing data that suggested progress on inflation had stalled, April's modest decelerations were enough to ease investor concerns about a resurgence in prices and quash speculations that the next Fed policy move would be an interest rate hike rather than a cut. One month of data does not a trend make, and while inflation is likely to remain elevated above the Fed's 2% target for some time, we anticipate that its gradual cooling in the months ahead could provide a tailwind for Equities.

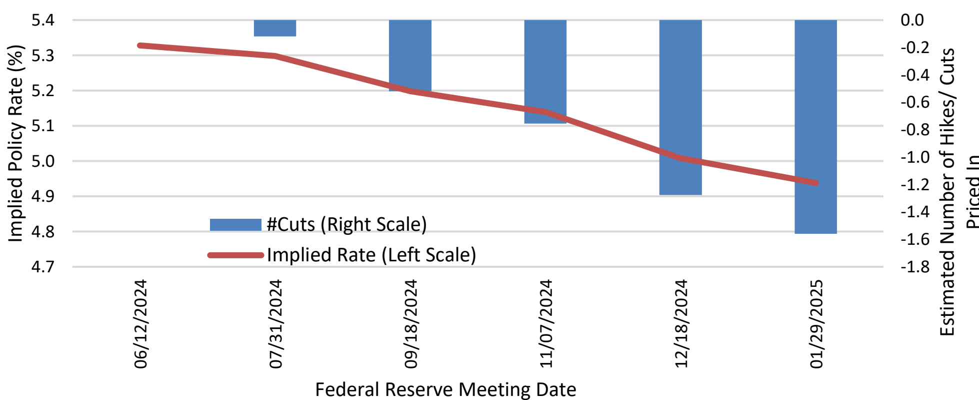
Exhibit 3: Data Suggests Inflation Has Resumed Its Gradual Cooling.



Source: Bloomberg. As of May 29, 2024.

Driver #3: Expectations for easing: Investors also weighed a variety of mixed-to-moderating economic data releases last month that suggested easier policy could be ahead, including sluggish retail sales, lackluster housing data, and stagnant industrial production. Weaker economic data is, somewhat counterintuitively, still being taken as a mostly welcome signal for Equities. Central to this dynamic is a belief that a softer economy paired with cooling inflation will lead to lower interest rates. After digesting May's data, investors are pricing in a 50% chance of an interest rate cut by the September Federal Open Market Committee (FOMC) meeting and a 100% chance of a cut by the December FOMC meeting (Exhibit 4). Our view is that economic data will continue to soften modestly as inflation cools in the months ahead, enabling the Fed to begin cutting later this year.

Exhibit 4: Implied Overnight Rate & Number of Cuts.



Source: Bloomberg fed fund futures data. As of May 29, 2024.

On one hand, we think the key supports behind May's market action are likely to remain in place. Our base case is that softening economic data, along with the gradual cooling of inflation, could allow for easier monetary policy moving forward, while the earnings recovery should continue. On the other hand, potential headwinds continue to mount, including concerns about extended valuations, possible election-related volatility as November creeps closer, and simmering geopolitical tension that seems to escalate daily.

Adding it all up, while the risk for episodic volatility persists, we maintain a constructive view on Equities and ultimately believe that the secular bull market remains intact. Bouts of weakness should continue to be viewed as buying opportunities for long-term investors.

THOUGHT OF THE WEEK

How Much More Can the World Import from China?

Ariana Chiu, Wealth Management Analyst

As the world braces for a manufacturing export deluge from China, it's helpful to remember just how much global trade has shifted since the start of the century. Exhibits 5A and 5B illustrate: In 2000, just five countries called China their top source of goods imports, while the U.S. led the world as the No. 1 import source for 42 countries. Fast forward to today, and the script has flipped dramatically. China is now the top source of imports for 66 countries—or roughly 1 in every 3 countries globally, per 2023 data.

And China's export footprint is only set to grow from here—or so it hopes. At the core of the country's growth strategy is its subsidization of clean technology, including EVs, lithium-ion batteries, and solar panels (the so-called "New Three"). Already, excess capacity has driven exports of the three products up from $20 billion in 2017 to over $150 billion in 2023.[6]

The wrinkle for China? A rising tide of global protectionism—ala the U.S.' recently unveiled 100% tariffs on EVs from China, or the EU's ongoing antidumping investigations. This is not to mention mounting scrutiny from emerging countries including India, Brazil, and Indonesia. In other words, unlike the first "China Shock" of the 2000s, many nations are resisting China's coming renewable trade push for the sake of their own production and employment security.

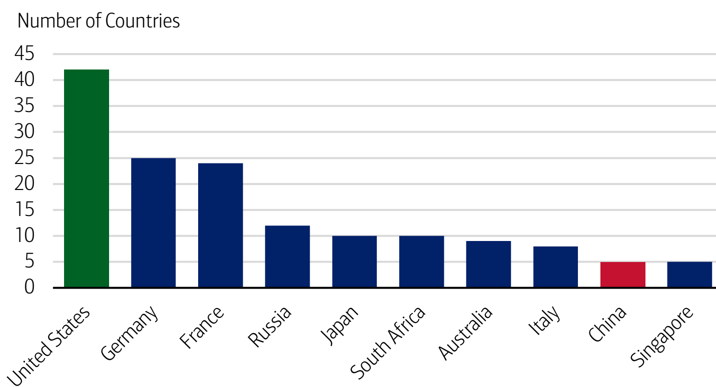
What does this mean for investors? With an excess of countries already deeply reliant on China, we expect the wave of targeted protectionist measures from the U.S., EU, and the emerging world to continue. Further protectionism—as well as any retaliatory action from China—will be costly for governments, corporates, and consumers alike, particularly when it comes to "New Three" products. Pushing back on China could entail slower global growth/trade and the buildup of excess capacity (think falling profit margins) along the global renewable supply chain as each region of the world strives for self-sufficiency.

Investment Implications

Dependence on China is not a U.S.-specific story—it's global, particularly when it comes to clean technologies. Now, many nations are resisting. Further protectionism from the U.S., EU, and beyond bodes for slower global trade and higher costs along the global renewable supply chain.

Exhibit 5: From 2000 to Now: A Shift in Global Order.

5A) In 2000, 5 Countries Counted China as Their #1 Import Source.



5B) Today, 66 Countries Count China as Their #1 Import Source.

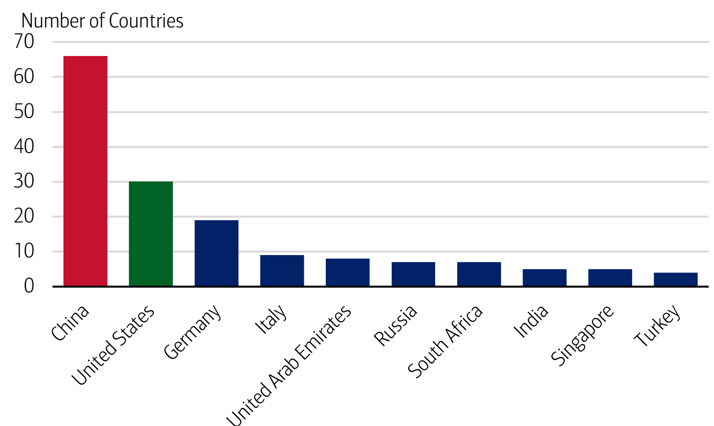


Exhibit 5A) Refers to 2000 annual data. Source: IMF Direction of Trade Statistics. Data as of May 2024. Exhibit 5B) Refers to 2023 annual data. Source: IMF Direction of Trade Statistics. Data as of May 2024.

[6] "China Green Trade Report 2023," Griffith Asia Institute, April 2024.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	38,686.32	-0.9	2.6	3.5
NASDAQ	16,735.02	-1.1	7.0	11.8
S&P 500	5,277.51	-0.5	5.0	11.3
S&P 400 Mid Cap	2,982.86	0.2	4.4	7.9
Russell 2000	2,070.13	0.0	5.0	2.7
MSCI World	3,445.17	-0.5	4.5	9.5
MSCI EAFE	2,355.67	-0.1	3.9	7.1
MSCI Emerging Markets	1,048.96	-3.1	0.6	3.4

Fixed Income†

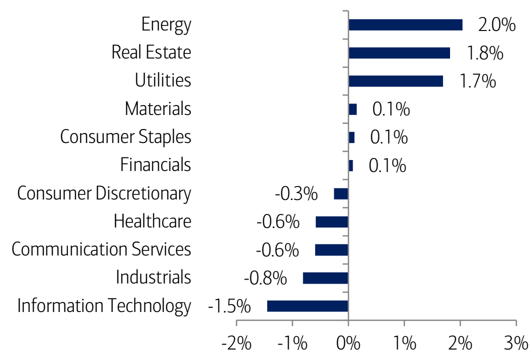
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	5.00	0.05	1.60	-1.53
Agencies	5.05	0.14	0.98	0.07
Municipals	3.93	-0.45	-0.29	-1.91
U.S. Investment Grade Credit	5.10	0.04	1.70	-1.64
International	5.52	0.09	1.87	-1.12
High Yield	8.00	-0.01	1.10	1.63
90 Day Yield	5.40	5.40	5.39	5.33
2 Year Yield	4.87	4.95	5.04	4.25
10 Year Yield	4.50	4.47	4.68	3.88
30 Year Yield	4.65	4.57	4.78	4.03

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	241.80	-1.8	1.8	6.8
WTI Crude $/Barrel††	76.99	-0.9	-6.0	7.5
Gold Spot $/Ounce††	2327.33	-0.3	1.8	12.8

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.08	1.08	1.07	1.10
USD/JPY	157.31	156.99	157.80	141.04
USD/CNH	7.26	7.26	7.25	7.13

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 5/28/2024 to 5/31/2024. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 5/31/2024 close. Data would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend. **Past performance is no guarantee of future results.**

Economic Forecasts (as of 5/31/2024)

	2023A	Q1 2024A	Q2 2024E	Q3 2024E	Q4 2024E	2024E
Real global GDP (% y/y annualized)	3.0	-	-	-	-	3.0
Real U.S. GDP (% q/q annualized)	2.5	1.2	2.0	2.0	2.0	2.4
CPI inflation (% y/y)	4.1	3.2	3.5	3.2	3.0	3.2
Core CPI inflation (% y/y)	4.8	3.8	3.6	3.6	3.5	3.6
Unemployment rate (%)	3.6	3.8	3.8	3.9	3.9	3.9
Fed funds rate, end period (%)	5.33	5.33	5.38	5.38	5.13	5.13

The forecasts in the table above are the base line view from BofA Global Research. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts. Historical data is sourced from Bloomberg, FactSet, and Haver Analytics. **There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.**
A = Actual. E/* = Estimate.
Sources: BofA Global Research; GWIM ISC as of May 31, 2024.

Asset Class Weightings (as of 5/7/2024)

	CIO View				
Asset Class	Underweight		Neutral		Overweight
Global Equities				●	
U.S. Large Cap Growth			●		
U.S. Large Cap Value				●	
U.S. Small Cap Growth				●	
U.S. Small Cap Value				●	
International Developed		●			
Emerging Markets			●		
Global Fixed Income		●			
U.S. Governments				●	
U.S. Mortgages				●	
U.S. Corporates		●			
International Fixed Income			●		
High Yield		●			
U.S. Investment-grade Tax Exempt		●			
U.S. High Yield Tax Exempt		●			
Alternative Investments*					
Hedge Funds			●		
Private Equity			●		
Real Assets			●		
Cash					

CIO Equity Sector Views

	CIO View				
Sector	Underweight		Neutral		Overweight
Energy				●	
Healthcare				●	
Consumer Discretionary				●	
Industrials				●	
Information Technology			●		
Communication Services			●		
Financials			●		
Real Estate			●		
Utilities		●			
Materials		●			
Consumer Staples	●				

*Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors. CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio. Source: Chief Investment Office as of May 7, 2024. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index is a market-capitalization-weighted index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

Dow Jones Industrial Average Index is a stock market index of 30 prominent companies listed on stock exchanges in the United States.

Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock exchange.

Real Trade-Weighted Dollar Index compares the value of the dollar against the currencies of countries with which each of the 50 U.S. states trades. The real exchange rates are aggregated across countries for each state, using the average export share to the country since 1988.

Consumer Price Index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households.

Core Consumer Price Index is constructed on a monthly basis by the Bureau of Labor Statistics. In contrast to the median and trimmed mean measures of underlying inflation, the core CPI associates the noise in an aggregate price index with particular items—food and energy. The core CPI excludes food and energy prices from the CPI.

Important Disclosures

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